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Some Implications of Changing Global Economic Conditions, 1983

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This Memorandum was coordinated within the National Intelligence Council and with the Directorate of Intelligence. Comments are welcome and should be addressed to the author [redacted] Analytic Group, National Intelligence Council. [redacted]

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NIC M 83-10004
February 1983

Some Implications of Changing Global Economic Conditions, 1983

Scope Note

Information available as of 31 January 1983 was used in the preparation of this Memorandum.

This Memorandum takes a broad look at the changing global economic environment in 1983, a year in which strong underlying forces could trigger either a pronounced economic recovery or a steep economic downturn. It portrays some plausible economic outcomes and their implications for three key policy concerns—protectionism, international financial dangers, and a looming oil price slide.

Key Judgments

Western policymakers this year face an international economic environment delicately poised between an economic recovery more robust than expected and the danger of a sharp economic slide:

- A significant easing of inflationary pressures, the end of escalating oil prices, a leaner and tougher industrial capacity, and a pent-up consumer demand provide the potential for a vigorous upturn.
- A resurgence in US interest rates or an LDC financial crisis could trigger a sudden and sharp fall in global economy activity. The slide is unlikely to produce a depression because of the existing industrial-country social and financial safety nets.

The *dangers* will be particularly acute in the next six months or so:

- Many of the recently negotiated debt-restructuring agreements with key debt-laden Latin American countries could unravel. Even with debt relief their financial positions will remain perilous. Within LDCs, political pressure against further austerity measures will rise. Industrial-country commercial banks, meanwhile, will see their profit/loss positions deteriorate.
- A sharp oil price decline would raise the risk of a global financial shock because of increased concerns regarding the ability of Mexico and a few other oil-exporting LDCs to meet their financial obligations. If this immediate danger can be avoided, the lower oil prices will become an important economic growth stimulant.

Strong protectionist sentiment will persist through 1983:

- Unemployment will remain high throughout the industrial world no matter what the economic pattern; even with a modest recovery, the US trade deficit will mount to record proportions.

- Some increase in minor protectionist moves will probably take place, in part because industrial countries with more open markets—like the United States—could react against other industrial countries that refuse to liberalize their markets.

- But an extremely harmful protectionist trade war among industrial countries is unlikely.

Industrial-country governments have much less potential in this recession to stimulate economic activity through traditional monetary and fiscal policies. Damage-limiting actions will thus receive more than usual attention:

- In the next few months, the focus is likely to be on finding innovative means of easing the financial plight of key LDCs.

- Toward midyear, the protectionist issue may receive prime attention.

The May 1983 economic summit in Williamsburg will present an excellent opportunity to initiate damage-limiting measures aimed at restoring confidence in the international economic system.

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Political-Economic Setting

Economic stagnation within the industrial world has persisted since mid-1980, with growth of GNP in the OECD countries averaging less than 1 percent per annum. For the first time since World War II, the recession has been truly global. While the 1974-75 downturn was largely limited to industrial countries, this time economic activity also has slowed sharply in both oil-exporting and oil-importing LDCs and in East European countries. After mid-1982, conditions took a turn for the worse. World trade declined sharply as a result of the cumulative effect of the prolonged slowdown on industrial countries and the sharp decline in LDC imports, especially for major markets such as Argentina and Mexico.

Table 1
Private Savings Available After Subtracting General Government Deficits

As a Percent of GNP

	1960	1970	1980	1981	1982
Japan	24	35	24	23	22
United States	16	15	16	17	14
France	20	22	19	17	16
West Germany	24	22	17	15	15
Italy	22	20	18	14	15
United Kingdom	14	15	13	13	13

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So far disruptive political tensions within and among industrial countries have been kept in check by domestic "social safety" nets and by international arrangements that have helped avoid "beggar thy neighbor" policies. These stabilizing systems, however, are under severe strain. Industrial-country governments are having great difficulties in sustaining the level of social payments in the face of growing budget deficits. Protectionist forces are building within the industrial world as many groups that heretofore favored free trade press for government actions aimed at insulating home markets from foreign competition or providing export subsidies. Among the LDCs, meanwhile, many large debtors face increased austerity.

Reduced Government Policy Options

Industrial country governments are playing much less a role in fostering economic recovery than was the case in previous post–World War II recessions. Much of their efforts are being devoted to limiting the damage caused by international financial problems and rising protectionist sentiment.

Most governments are either unable or unwilling to stimulate economic activity through traditional policies. "Pump priming" no longer seems a viable option for most countries. Budget deficits throughout the industrial world have reached extraordinarily high levels because, in addition to a rapid rises in social welfare spending in the 1970s, the prolonged recession has meant soaring outlays on income maintenance and declining revenues. This has created a policy quandary. While fiscal stimulation would spur economic activity and eventually help lower budget deficits, governments are reluctant to initiate such measures because they are apprehensive about even a temporary rise in deficits. Financial leaders fear that high deficits will keep up interest rates, thereby halting economic expansion. As a result, even socialist governments of Western Europe—those of Sweden and France—are pruning social outlays in order to cut back budget deficits. Only the United States is pursuing expansionary fiscal measures, mainly through tax cuts.

Among industrial countries, Japan has the most fiscal maneuverability. Its private savings as a share of GNP, after subtracting general budget deficits, are by far the highest among industrial countries (see table 1).

As a result, Tokyo could probably expand government spending significantly without pushing up interest rates or fanning inflationary pressures. A strong desire among Japanese political and financial leaders to avoid large budget deficits, however, is keeping Tokyo from extensively employing this fiscal tool.

The ability of governments in Western Europe and Japan to pursue easier monetary policies is also constrained. They believe the United States must act first to reduce high real interest rates because, if they took the initiative, their currencies would weaken vis-a-vis the dollar, leading to higher domestic inflation. Tokyo also fears that a weakened yen would exacerbate US-Japanese trade tensions because of the price advantages accruing to Japanese exporters. As a result, West European and Japanese leaders would like to see the United States cut its budget deficits in order to bring down interest rates.

Another often-mentioned option for stimulating global economic activity is for industrial-country governments to provide LDCs with increased financial assistance and improved market access. The additional financial inflows would help replace the reduction in new commercial bank lending to LDCs. In theory, such moves would generate increased industrial-country exports and higher economic growth for all parties. In practice, industrial-country governments are unlikely either to provide massive funds—because they are financially strapped—or to grant greater market access in the face of high unemployment at home.

The Year Ahead

The consensus forecast envisages a modest recovery beginning in the United States. GNP growth here is expected to increase by 3 percent per year, as compared with a 6-percent average rebound attained in the first year of other post–World War II recoveries. The economies of Western Europe and Japan are forecast to begin their upturn around midyear, with a second-half expansion of a mere 2 and 3 percent respectively. Neither the LDCs nor the East European states are expected to show any significant signs of recovery until 1984 at the earliest.

Although such a halting recovery is accepted as the most plausible outcome, the chances are better than even that some other cyclical path will result. As experience has amply demonstrated, the timing and magnitude of cyclical trends most often turn out to be much different from the consensus view. In the past 15 years of strong cyclical movements, the tendency has been to significantly underestimate both the downturn and upturn. The 1975 recovery, for example, was predicted to be modest but turned out to be robust. The unique features of this cycle make forecasting that much more difficult.

Below are some plausible alternative cyclical patterns for industrial countries in 1983:

- *A sharper-than-expected economic pace in the early-to-middle part of the year, led by a vigorous US recovery.* The path could result from unleashing the considerable pent-up demand in housing and consumer durables. Once demand begins to pick up, the more optimistic mood would make the expansion self-reinforcing. Consumers are in a good position to spend more because their installment credit position is more manageable and their savings are higher than a few years ago. Inventories have declined to the point where an increase in demand could spark increased output. Producers would be able to expand output without raising prices much because of excess capacity and because they have shed many of their least competitive activities. Economists are now beginning to give this possibility greater credence because of the favorable economic data in recent weeks.

- *A further delay of six months or more in the recovery, with continuous economic stagnation.* A resurgence of high interest rates or some other adverse factor—a new financial shock—might impinge on economic recovery. The resulting pessimism would hold down consumer spending and lead to further cuts in business capital outlays.

- *A sharp dropoff in economic activity within the next six months followed by an equally sharp upturn.* The present unsettling economic and financial atmosphere makes the global system particularly prone to shocks that could trigger an economic decline. It is conceivable, for example, that a financial panic could be caused by the inability or unwillingness of some major LDC or company to meet its financial obligations. In the resulting atmosphere of fear and uncertainty many businesses would be forced to sharply cut all but cash-and-carry transactions. Although these conditions could produce a depression, the chances of such a dire consequence seem low considering the underlying strength of the industrial world and existing social and financial safety nets. Industrial country central banks would most likely prop up the commercial banks under their control and the high level of social welfare payments would stabilize consumer spending. As a result, a more plausible scenario would be a sharp follow-on recovery that would in a quarter or two bring global economic activity at least back to near the 1982 level. The momentum of the expansion in turn could lead to a sustained upturn.

- *A pause in the recovery beginning in late 1983 or early 1984.* Recovery is adversely affected by a surge in interest rates resulting from an earlier rapid increase in the money supply.

All these plausible cyclical scenarios possess common threads:

- The timing and the pace of the recovery will depend heavily on US economic performance.

- The global economy will be especially prone to sudden shocks to its trade and financial systems.

Key Issues

The major international economic issues policymakers will face in 1983 are well known, although the outcome is far from clear. Protectionist sentiment will remain strong, and the global financial situation will continue to be precarious. A third major influence looms on the horizon: the possibility of a sharp decline in oil prices. All three of these potential problems are intricately linked through the highly interdependent global economic system. Each has the potential for triggering a further global economic slide, and each would be adversely affected if one of the others occurred. For example, if a number of debt-laden LDCs declare an indeterminate moratorium on repayment of principal and interest, they could cause a global financial shock. World trade would fall sharply because of the reduced ability of LDCs to import and the disruptions in trade financing. As a result, a major industrial country might take strong protectionist steps in order to try to isolate itself from the growing global economic difficulties. Other nations would probably follow suit to prevent a massive diversion of goods to their markets. The faltering global economic demand could cause a sharp decline in oil prices, which would further aggravate the economic plight of such major oil exporters as Mexico, Nigeria, and Indonesia. In turn, world trade would decline further and the economic slide would accelerate.

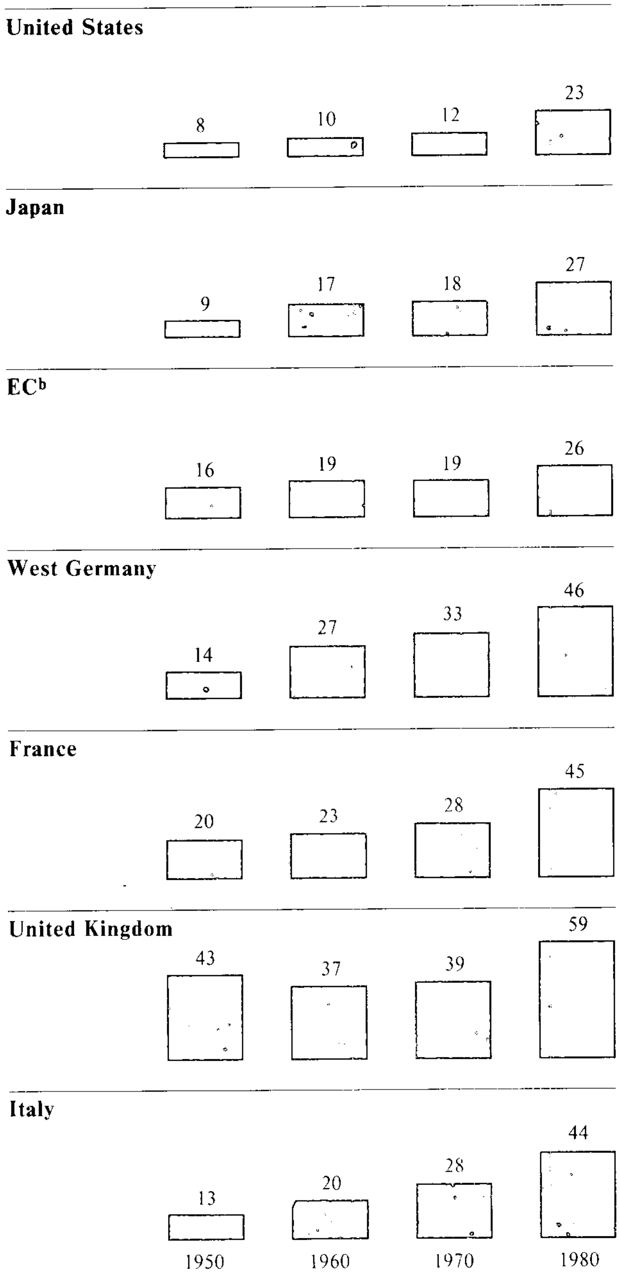
Neomercantilism and Protectionism

Protectionism is the most elusive of the three key issues discussed. Although the degree of public sentiment on the issue can be reasonably gauged, it is extremely difficult to know when protectionist pressures will reach the point at which they will result in actions (rather than only rhetoric) that could seriously disrupt global economic activity. In part, this reflects the fact that no such disruptive event has occurred in nearly 40 years.

The Changing Environment. Protectionist pressures clearly are growing stronger. The prolonged recession is eroding the belief in free trade, especially because job losses have been particularly pronounced in the highly visible and regionally concentrated smokestack industries. As a result, governments are showing an increased inclination to shield their countries' markets from foreign competition and to take other neomercantilist actions such as export subsidies. Moreover, the limited maneuverability governments now have in using traditional antirecessionary policy tools is placing greater emphasis on protectionism as a possible

Figure 1
Growing Interdependence

Exports as a percent of production of goods[a]



[a] Value added in agriculture and industry.
[b] Excluding intra-EC trade.

option. The Mitterrand administration in France, for example, already has shown strong signs of moving in that direction. Even the Thatcher government in Britain, despite its championing of free trade policies, has been contemplating import restrictions.

A number of broadly based trends are making protectionist tendencies more difficult to resist:

- The importance of foreign trade to each industrial country's economy has grown enormously in the last 30 years and especially in the past decade (see figure 1). Although this increased dependence has made countries more cautious in their use of protectionist practices, it has greatly magnified the problem of domestic industrial disruptions caused by imports.

- Multilateral trade liberalization agreements have become less potent as a tool in the battle against protectionism. Most of the highly visible restrictions—tariffs and quotas—have been reduced to the point (among industrial countries) where they no longer are major trade restraints. The remaining barriers are considerably more difficult to remove because they are subtle and elusive and harder to attack.

- The flexible foreign exchange regime introduced in the early 1970s has meant that currency movements are playing a much-increased role in determining relative trade performance among industrial countries. Because these fluctuations are influenced by capital as well as trade flows, exchange rates do not always track with changes in trade competitiveness. This situation can greatly stimulate protectionist pressures.

Cyclical Implications. Strong protectionist sentiments are likely to persist throughout 1983 no matter which way the global economy turns. Unemployment throughout the industrial world will remain painfully high under all possibilities. The best that can be expected under the most optimistic scenario is a slight decline after midyear from the present high levels. The consensus forecast predicts that US unemployment will level off in early 1983 and remain near 10 percent throughout the year. European joblessness is

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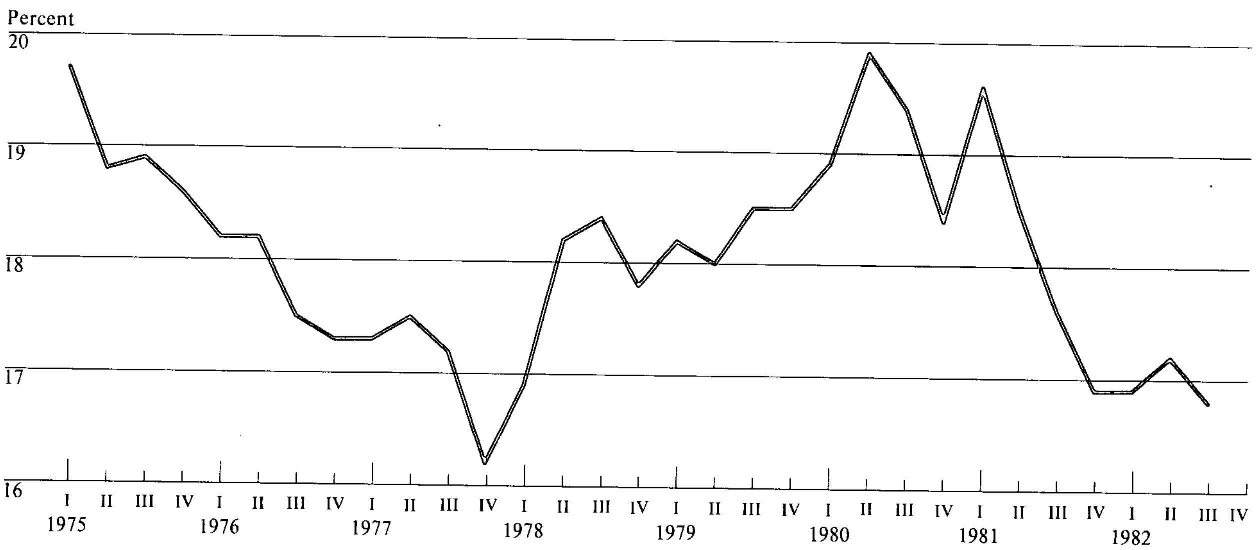
Figure 2
United States: Share of OECD Exports
Constant 1975 Dollars



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expected to grow well into 1984. At the other extreme, a further sharp decline in economic activity could push up the jobless rate to an even more unsettling level.

Although the consensus and high-growth scenarios would greatly ease pessimism concerning future unemployment rates, they would create another source of protectionist sentiment. With the United States leading the recovery, its trade deficit will grow sharply, reaching record levels. Exports of goods and services will not begin to move up significantly for many months because of the slow economic growth in foreign markets and the residual effect of a strong dollar. As shown in figure 2, the US market share among industrial countries by mid-1982 had already dipped to the lowest level since 1977. Meanwhile, imports would soar to feed the US economic upturn. As a consequence of the large trade deficits, protectionist pressures could continue to build in the United States.

Toward the end of 1983 the source of protectionism could begin to shift. The massive US trade deficits, would probably cause the dollar to weaken against other major currencies, especially the yen. In fact, partially in anticipation of a rising US trade deficit, the dollar already is beginning to weaken. (Our growth scenarios assume that the US expansion is not accompanied by expectations of inflation that would push up interest rates to the point where the dollar would strengthen significantly.) Other countries would soon find that their export markets were being lost to more price-competitive US goods. Plagued by continued high unemployment, many foreign government and business leaders might charge that the United States was undertaking a competitive devaluation to boost exports and might be tempted to do the same.

Dimensions of the Problem. So far during this recession, neomercantilist sentiment has been largely checked. "Beggar thy neighbor" actions have been limited—especially considering the duration of the downturn, the high level of unused industrial capacity, and the record post–World War II rates of unemployment. Some additional import restraints have been put in place in Western Europe and North America mainly to protect basic industries. At the same time, however, tariffs have been cut as planned under the Tokyo Round of multilateral trade discussions, Japan has continued gradually to open up its market, and poor economic conditions have increased global competition in such markets as those for steel and oil. Although the volume of international trade fell in 1981 and 1982, the drop was almost entirely due to the recession and the severe foreign financial conditions faced by many LDCs and East European countries.

An important factor in containing protectionist sentiment has been the considerable publicity given to the general dangers and roots of neomercantilism. In part, however, because the problem has been contained for so long, little attention is being paid to such fundamental issues as to how a trade war might develop, its implications, and the impact of an accumulation of less severe neomercantilist actions. These questions will be addressed in a subsequent memorandum that deals solely with the neomercantilist issue. Meanwhile, a few generalizations seem reasonable to make.

The possibility of a disastrous trade war reminiscent of the 1930s seems low, despite the constant public warnings of such an occurrence. If there is a trade war, it is likely to be caused by an economic depression and we believe that is a low-probability event. Under less dire economic circumstances it is difficult to envisage a plausible sequence of events whereby a protectionist move by one country would spark widespread retaliation or emulation.

Trade tensions nevertheless could increase as a result of numerous but less severe and more subtle protectionist moves. In this regard, the United States now seems a possible source of such actions because its market is more open to foreign goods and it provides fewer subsidies to exporters than other countries. As a consequence, the United States might react to failure by Japan to open its markets sufficiently, to intransigence in the European Community on the agricultural subsidy issue, or to the expected burgeoning of US trade deficits. Japan is highly unlikely to initiate new barriers and thereby create even greater anomosity toward its trade practices. Significant new EC barriers seem highly unlikely mainly because more than half the trade of EC members is with other members of the group. The EC might impose some additional restrictions on Japanese goods, but these barriers are unlikely to be major because individual countries already have numerous controls on Japanese exports. LDCs are unlikely to play much of a role. Most already impose highly restrictive import barriers, and the developed countries probably would not oppose tighter LDC import controls because they realize such actions would be needed to overcome severe financial difficulties.

The Changing Nature of Financial Dangers

Phase Two Begins. The international financial crisis is entering a new phase. By late 1982, Western financial and political leaders had become acutely aware of the gravity of the LDC financial problems and had recognized the need for cooperative action to prevent the LDC difficulties from triggering a global economic and financial crisis. Now these leaders are dealing with the grueling and necessary task of dividing between borrowers and lenders the political and economic costs involved in overcoming financial difficulties.

Much progress was made in the first phase. Consultations and discussions aimed at better managing the potential dangers increased enormously among the key actors—governments of both creditor and debtor nations, the private financial community, and the International Monetary Fund. Widespread support developed for the key role of the IMF. Industrial countries became more willing to ensure that it has adequate lending resources. Key debtor governments signed preliminary agreements with it involving the acceptance of additional austerity at home in exchange for funds that can ease their adjustment plight.

The current account deficits of LDCs and East European countries also were cut substantially. The reductions were forced on Argentina, Mexico, and Poland as they ran out of foreign exchange and were unable to borrow. A number of other countries "voluntarily" cut back imports to avoid a forced reduction. Some accepted the lower imports as part of a debt rescheduling or restructuring arrangement while others, mainly East European countries, undertook especially sharp import cutbacks because they wanted to avoid a rescheduling, if at all possible. As a result, most East European countries eliminated their current account deficits last year and the LDC deficits have been cut by at least $10 billion. While most countries will have to continue to trim imports, the magnitudes will probably be small relative to what has already taken place, unless there is a further slide in industrial-country economic activity. A major exception is Brazil, which plans to cut imports an additional 15 percent.

Phase Two Problems. The problems, however, are far from over for both the debtor and creditor nations. In 1983 the process of overcoming the international financial difficulties will most likely reach its most painful point in terms of economic sacrifices made by the LDCs and the reduced profits (and possible losses) that commercial banks will have to endure. Each side will be trying to shift the burdens involved to the other, and both will be applying intensive pressure on the industrial-country governments and the IMF to provide more relief. Negotiations among the key players will be arduous, seemingly endless, and, at times, caustic. Because of this turbulent environment, a global financial panic sparked by debt problems will remain a low probability but an unusually worrisome possible outcome.

The initial shock created by the sharp falloff in imports is passing for many key LDCs, but these countries now face the more arduous task of coping with austerity, lowered expectations, and a reduced standard of living. In part, these conditions result

Table 2
Real GNP Trends

	Percent of change from previous period, at annual rates					Commercial Debt (*Billions $, end of 1982*)
	1980	1981	1982 [a]		1983 [b]	
Argentina	−2	−6	−5		+5 to −5	33
Brazil	8	−2	0		−2 to −10	68
Yugoslavia	2	2	1		0 to −2	12
			1982 1st half	1982 2nd half		
Mexico	8	8	4	−3	−2 to −4	75

[a] Estimated.
[b] Projected.

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from the IMF economic adjustment programs that call for wage restraints, cuts in budget spending, higher taxes, and reductions in consumer food subsidies. While some 30 LDCs and East European countries that rely heavily on foreign commercial banks are facing severe financial troubles, four of these countries, because of their huge debts, are by far the most important in terms of the stability of the international financial system. In this group, *Mexico* and *Brazil* face the greatest additional economic sacrifices this year (see table 2) but are in a best position to cope with the difficulties because of their durable political and social systems. The economy of *Argentina* has been declining since 1980 and the country's political milieu is highly unstable. There is a small chance that a highly populist regime might come to power and repudiate the country's foreign debt. *Yugoslavia* is a sleeper. Economic growth has been low since 1980, standards of living have fallen, and the post-Tito leadership has been unable to agree on ways out of the country's economic fix because of strains caused by decentralization and ethnic differences. Despite a substantial Western aid package, a prolonged period of political instability could lead to a financial crunch and a halt in debt servicing.

Commercial banks in 1983 will face lower profits and increased uncertainties as to the quality of their loan portfolio. An increased number of cross-border loans are likely to be written off, and, more important, many more of these loans could be considered "nonperforming"—that is, credits on which no interest has been received for a specified period (often 90 days). At the same time, the commercial banks will no longer benefit, as they did in the second half of 1982, from a much steeper decline in the rate they pay for money than the rate they charge their customers.

Commercial banks also will continue to be under enormous pressure to increase their exposure to debt-ridden LDCs as a necessary and integral part of rescheduling agreements. Even though these loan disbursements are unlikely to exceed by much the amounts commercial banks receive in debt service payments, bank stockholders and regulators will question new credits. The small and medium-size US banks and foreign banks will be particularly reluctant to provide new funds. Without these banks—which account for two-thirds of the lending to the troubled countries of Argentina, Brazil, and Mexico—the leading nine US banks would be stuck with an enormous share of the risk, a situation that could raise solvency questions.

Finally, the amount of rescheduled debt will jump considerably this year, reaching a level that may not be topped for many years, if not decades. Key Latin American debtors and some others, including Romania, already have declared they can no longer meet scheduled debt repayments. Bankers have virtually no choice but to stretch out debt repayments. To meet this challenge, a number of innovative financial arrangements are emerging. The more financially sophisticated LDC governments are unilaterally introducing new arrangements, and most are being accepted by the lenders. For example, the Argentine Government is issuing transferable bonds due in five or more years to replace loans that have not been serviced for months. Mexico City plans to pay in installments the interest (in dollars) on the debt owed by private Mexican companies to foreign banks. At the international level, the IMF and the commercial banks are working more closely to develop debt-relief agreements.

Some of these arrangements will fail because of a continuing lack of confidence in the debtors repayment capabilities. This could arise because a debtor country's export potential is poor or because creditors feel that an LDC government is unwilling or unable to follow through on the IMF austerity measures. Thus, new financing endeavors will have to be negotiated. In fact, for most major LDC debtors the rescheduling process is likely to be continuous. The real danger—most serious through midyear—is that the ad hoc refinancing devices will not be adequate. It is conceivable that the emergency financing being provided by the United States, the IMF, the Bank for International Settlements, and the major US commercial banks will do nothing more than compensate for an equally large or larger LDC short-term capital outflow caused by many small creditors trying to reduce their exposure and by nationals of the debtor country trying to move funds to industrial countries.

If the financial drain continues for long, the burden on the emergency lenders will become excessive. Once that point is reached, new and more comprehensive international schemes may be put in place. A number of such new approaches already are being mentioned. Under many of these schemes the IMF would tap private markets (central banks) and lend the proceeds to LDC debtors.

Sensitivity to Global Economic Trends. The financial issue in 1983 will be particularly sensitive to global economic trends. The economic growth outcome will have its most pronounced impact on the mood of the international financial community. If the recovery seems to be unquestionably under way (and especially if the expansion exceeds the consensus forecast), lenders will be much more inclined than at present to provide additional loans to tide the LDCs over until better times. Although the probable expansion of LDC exports accompanying the more rapid growth scenario would not eliminate foreign financial constraints to growth for several years in some countries, the forward momentum would provide some hope for the future, thereby alleviating political tensions. Moreover, the growth scenarios envisage a continuing decline in interest rates. Under these circumstances, the commercial banks are likely to be somewhat more forthcoming in providing new loans. If pessimism prevails as a result of six or more months of economic stagnation or decline, the risk could rise substantially that a key LDC would declare an indeterminate debt moratorium or (much less likely) repudiate its debt, and the action could spread quickly to other LDCs. The worst of all worlds would be a recovery held in check by rising interest rates.

The Looming Oil Dangers [1]

A sharp decline in oil prices would lead to significant benefits for the global economy within a few months but also would create potentially dangerous immediate problems, especially if the oil price fell below $25 per barrel. The main concern would stem from the inability of a few key LDC oil exporters, especially Mexico, to meet their financial obligations. The specter of a global financial panic would almost certainly increase. An oil price decline of $10 to $15 per barrel from the current level of $34 per barrel would mean a 30- to 40- percent cut in the oil revenues of exporting nations. Since most of these countries derive 90 percent more of their export earnings from oil, their exports would drop by nearly the same proportion. For some oil exporters—Mexico and Nigeria, for example—imports would have to be reduced by a similar amount because they have almost no foreign exchange reserves and little or no capacity to borrow. Other countries such as Indonesia and Venezuela would also be forced to cut back imports significantly and would have difficulties borrowing from private sources.

In addition, the United States and the United Kingdom as major oil producers would suffer some immediate problems. Their currency values would probably deteriorate, although the dollar might be propped up by "safe haven" capital inflows resulting from worries over the ability of some LDC oil exporters to meet their foreign financial obligations. The pound sterling already has declined sharply, partly in anticipation of falling oil prices. It thus may be necessary to keep up interest rates to avoid especially large currency shifts. Concerns about the depressing impact on the oil and other energy producers in the industrial world would be felt before the consumer benefits began to have a strong influence. Some energy facilities under construction or put in place in recent years would become uneconomic, especially below $25 per barrel. Many investments would be canceled and some recently completed plants would be shutdown. A number of energy companies and investors probably would go bankrupt. Some producers would call for protection from cheap foreign energy sources.

Cyclical Impact. Oil demand and prices are greatly influenced by the course of the business cycle. Shifts in oil demand over the business cycle far exceed changes in other energy sources or in industrial activity because oil is the most flexible source of energy. While global economic output rose slightly between 1979 and 1982, energy usage fell by some 5 percent and oil production 20 percent. Even though some 60 percent of the oil decline is related to conservation and fuel switching, the cyclical component is large. Moreover, the cyclical-related changes in oil demand fall most heavily on OPEC and especially Saudi Arabia as the supplier of last resort. Between 1979 and 1982, OPEC oil production declined 40 percent, as compared with the 20-percent falloff in global oil output.

Oil prices meanwhile have been greatly influenced by OPEC and Saudi efforts to administer prices and change production levels. OPEC has halted a major price slide by cutting back production to match demand. OPEC members, however, have had to live with oil revenues that fell far short of what they consider their minimal needs. As a result, some countries have been cutting prices to enlarge their market share and thereby increase revenues. A decline in oil prices of much more than $5 per barrel so far has been prevented only because the Saudis have accepted a much-reduced oil market share.

Given these market fundamentals and the normal seasonal falloff in oil demand there will be strong downward pressures on oil prices for the next six months or so. After that, if economic growth turns out 25X1 to be in the optimistic end of range of plausible scenarios, OPEC production could move up to 22-24 million b/d, a level sufficient to provide most of OPEC members with enough sales, at $30 per barrel or more, to meet their minimum revenue needs. These circumstances would also help keep Mexico's financial situation from deteriorating much further. Under either of the pessimistic scenerios—a sharp temporary decline in economic activity or a further stagnation—the odds of a sharp drop in oil prices would persist as OPEC production would remain below 20 million b/d. The consensus forecast has slightly more than an even chance of touching off a price decline. In that instance, price movements would hinge on a major unknown—the depth and persistence of conservation trends.

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